

CC:P&SI:TR-45-1096-91
Br6:JEMoffat

AUG 28 1991

Assistant Regional Commissioner (Examination) E:T3
Attn: Chuck Butler, Regional Technical Coordinator
Central Region

Assistant Chief Counsel CC:P&SI
(Passthroughs and Special Industries)

TCR 17,901 (Ex. TCR 91-103)--Luxury Automobiles
Depreciation Rule 280F(a) and Leasing Rule 280F(c)(2)

Attached is our response to the request for a Technical Coordination Report submitted by Mr. Kenneth G. Kline of the Cleveland District on April 12, 1991. The agent suggested that lessees of automobiles receive more generous tax treatment than owners of automobiles. Further, he suggested that capitalization of lease payments with expense limitations would be more equitable than current treatment.

An automobile lessee may recover lease costs over the term of the lease and an automobile owner may recover costs over the period of ownership. Generally speaking, leasing costs will exceed acquisition costs so that the lessee's total deductions for a given term of years will exceed an owner's deductions for the same number of years. Depreciation limitations are imposed on the owner, and the regulations require lessees to add an inclusion amount to income to effectively limit lessee deductions. If the lessee were required to capitalize its lease payments and be permitted an annual deduction similar in amount to the depreciation limitations on an owner, the difference from current treatment would be slight. Thus, we do not recommend a change in the treatment of lease payments. Attached is a memorandum providing a detailed explanation of our analysis.

We appreciate the contribution made by Mr. Kline in calling to our attention the differences in the tax treatment of automobile owners and lessees. We hope that he will continue to provide us with constructive ideas.

Please furnish copies of this memorandum to the appropriate persons.

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If you have any questions in this matter, please contact Mr. John Moffat of this office (FTS 566-3553).

PAUL F. KUGLER
Assistant Chief Counsel

(signed) Harold E. Burghart

By:

HAROLD E. BURGHART
Assistant to the Chief,
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Office of Assistant Chief
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Attachment: Memorandum for the File (Original & 5 copies)

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Memorandum for the File

Assistant to the Chief, Branch 6 CC:P&SI:6

TCR 17.901 (Ex. TCR 91-103)--Luxury Automobiles
Depreciation Rule 280F(a) and Leasing Rule 280F(c)(2)

The Cleveland District requested a review of the rental deductions allowed for short leases of luxury automobiles. The request suggests that, compared to owners whose depreciation deductions are limited by section 280F(a) of the Internal Revenue Code, short-term lessees receive generous tax treatment. One remedy would require lessees to capitalize lease payments and to recover the capitalized amounts through deductions similar to those allowed on depreciation of automobiles. An illustrative example containing a set of facts was submitted for our review.

Facts

The facts, as we understand them, are as follows:

A Cadillac Allante is leased on the first day of 1989 for a 2-year term at a rental payment of \$22,000 per year. The fair market value of the automobile at the beginning of the lease period is \$60,000 and the business usage for each tax year is 80 percent. The lease terminates on the last day of 1990.

For comparative purposes, the following example is discussed: a Cadillac Allante is purchased for \$60,000 and placed in service on the first day of 1989. The business usage of the automobile in 1989 and 1990 is 80 percent. The automobile is sold on the last day of 1990.

Regulations

The additions to gross income for deductions claimed by lessees of automobiles first leased after 1988 are determined from the instructions in section 1.280F-7T(a) of the temporary Income Tax Regulations and from the dollar amounts in the table of the appropriate revenue procedure.

Rev. Proc. 89-64, 1989-2 C.B. 783, 784, provides the inclusion amounts for an automobile first leased in calendar year 1989. Under section 1.280F-5T(h)(2) of the temporary regulations, the applicable inclusion amount for the Cadillac Allante is determined from the fair market value, defined as that value of the automobile on the first day of the lease term. Further, section 1.280F-7T(a)(2)(i) requires the inclusion amount in the last year to be the same as the inclusion amount for the prior year. Thus, the inclusion amount for the second year of a 2-year lease is the same as the inclusion amount for the first year of the lease.

Lease Deductions and Inclusion Amounts

For the Cadillac Allante with a fair market value of \$60,000 at the beginning of the lease period, Table 2 in Rev. Proc. 89-64 provides inclusion amounts of \$642 for each of the tax years, 1989 and 1990.

The deductions and inclusion amounts in the 2-year period with the lessee claiming an 80 percent business use are as follows:

	<u>1989</u>	<u>1990</u>	<u>Total</u>
Deduction Allowed (80% Per Year)	\$17,600	\$17,600	\$35,200
Inclusion Amount (80%)	<u><514></u>	<u><514></u>	<u><1,028></u>
Net Lessee Deduction	17,086	17,086	34,172

At the end of 1989, the stream of net lessee deductions discounted at 8 percent over the remaining period of the lease provides a present value of \$32,906 (\$17,086 plus \$15,820).

Capitalizing the Lease Payments (Proposal)

Capitalizing of lease payments and applying the section 280F(a) depreciation limitations to the capitalized amount year by year would result in deductions claimed over a 2-year lease term as follows:

	<u>1989</u>	<u>1990</u>	<u>Total</u>
Proposed Deduction for Capitalized Lease Payments	\$2,128	\$33,072	\$35,200

There would be no inclusion amounts and any capitalized amount remaining on termination of the lease would be allowable as a deduction in that year. At the end of 1989, the stream of deductions capitalized under section 280F and discounted at 8 percent over the remaining period of the lease would provide a present value of \$32,750 (\$2,128 plus \$30,622).

Depreciation and Loss on Resale

For the owner of the Cadillac Allante placed in service in 1989, the depreciation limitations under section 280F(a) are \$2,660 for 1989 and \$4,200 for 1990. Therefore, for the automobile owner claiming an 80 percent business use, the net deduction allowed under the limitations of section 280F(a) of the Code would be as follows:

	<u>1989</u>	<u>1990</u>	<u>Total</u>
Depreciation Deduction	\$2,128	\$3,360	\$5,488

However, any comparison of depreciation versus leasing deductions would be incomplete without an accounting for any loss and, hence, a deduction that may result on the sale of the automobile. For example, if the Cadillac Allante were sold in December of 1990 for its resale value of \$31,150 (National Automobile Dealer Association, December 1990) and its adjusted basis was \$54,512 (\$60,000 minus \$5,488), the owner of the Cadillac Allante may claim a deduction of \$18,690 (\$54,512 minus \$31,150 times 80 percent) for 80 percent of the loss on resale of the automobile. Total 1989 and 1990 deductions for the owner of the Cadillac Allante used in a trade or business would then be as follows:

	<u>1989</u>	<u>1990</u>	<u>Total</u>
Depreciation Deduction	\$2,128	\$3,360	\$5,488
Loss on Resale of Automobile		<u>18,690</u>	<u>18,690</u>
Total Deductions to Owner	<u>2,128</u>	<u>22,050</u>	<u>24,178</u>

At the end of 1989, the stream of deductions for an owner of the Cadillac Allante discounted at 8 percent over the remaining period of the lease would provide a present value of \$22,545 (\$2,128 plus \$20,417).

Comparison Using Present Values

The present values of the deductions at the end of 1989 for the owner and for the lessee under the alternate computations are as follows:

Net Lessee Deduction: \$32,906
Proposed Deduction for Capitalized Lease Payments: \$32,750
Depreciation and Loss Deductions to Owner: \$22,545

The present value of deductions for an owner of a Cadillac Allante are less than for a lessee of the same automobile. This reflects the greater cost of leasing (i.e., lessor costs and profit margins) over owning an automobile. Compared with the present method of requiring a lessee to add inclusion amounts to gross income, the proposed capitalization of the lease payments and limiting the annual

deductions do reduce the present value of deductions for leasing, but the difference is slight.

Conclusions

Based on this analysis, any additions to tax revenue from changing the rules on lessees would be marginal. Therefore, at this time there appears to be insufficient justification to recommend any change.

(signed) Harold E. Burghart

Harold E. Burghart